NIO/Econ/David Low
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OIL MARKET VULNERABILITIES

While oil market analysts debate the prospects for a steep decline in oil prices, there are some disturbing trends in oil supplies that portend a possible sharp increase in prices and increased reliance on Persian Gulf output a few years down the road. Exploration and development of oil fields in the United States has slumped badly.

-- The number of active drilling rigs is now only 40 percent of its 1982 peak.

-- Outlays for exploration and development in the United States will fall to around $25 billion this year compared to nearly $45 billion in 1982.

This trend reflects the impact of a $25 billion drop in oil company revenues and, likely, the increased debt costs from the $55 billion in recent oil company mergers. It also reflects, to a much lesser extent, some shift of activity by U.S. companies away from the "lower 48" to exploration and development activity in the LDCs.

-- The high level of U.S. exploration and development is the primary reason that, contrary to predictions made in the late 1970s, U.S. oil output has not declined this decade.

At the same time, OPEC's surplus production capacity is diminishing.

-- Saudi capacity has fallen by about 2 million barrels per day over the last two to three years, and Aramco is now debating whether it should continue to service some 2 million b/d of mothballed capacity.

-- Kuwait's surplus capacity has also slipped as prolonged market weakness has forced the government to limit spending on facilities.

Overall, OPEC ability to increase output is now 8 million b/d below its peak of 35 million b/d reached in the late 1970s.

None of this activity has any direct bearing on the current market.

-- The demand for oil in the West, which had been predicted to rise slightly this year, is still below 1984 levels based on data through April.

-- Downward pressure on prices has picked up again as a result of this slack demand and increases in Iranian production, now running at 2.5 to 3.0 million barrels per day.

It does portend, however, a relatively rapid decline in surplus capacity a few years out, particularly if governments in Western Europe decide to take stronger action to increase economic growth.

-- Present predictions of a slack market throughout the decade are based on a presumption that European governments will continue to follow deflationary policies despite high levels of unemployment.